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It's Not What You Make, But What You Keep, That Counts!

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Many of us have likely been courted by an advisor claiming they can get us more growth on our retirement income than our current advisor can. Growth in retirement is important, but it's not the only concern we face. Other, ever-growing concerns include those of rising health care, long-term care, volatile markets, and future tax rates. So, how can we begin to shift our thought process from just growth to these other important aspects of retirement? After all, it's not what we make, but what we keep, that counts.

Many retirees are unaware of potential tax hurdles in their retirement, and understanding these hurdles can go a long way to ensure we keep as much of our hard-earned money as possible. Let's start with Social Security – did you know that at your full retirement age, your Social Security may still be taxed? For example, if you are a married couple earning more than $44,000 a year in provisional income, your Social Security could be taxed up to 85%. Therefore, if you are bringing home $40,000 in Social Security income taxed at 85% (which would be $34,000), that amount has become taxable at your marginal rate. At a basic level, most people are counting on their Social Security income, and having a tax bill like that could greatly affect the retirement they have planned for.

Required minimum distributions (RMDs) play a large role in retirement, as well. Many people are not aware that, at age 73, (For those born after 1960, the number increases to 75.) our government requires us to take out 3.65% from our qualified plans (401(k), 403(b), traditional IRA, etc.). When we factor in RMDs, pensions, taxable accounts (brokerage, etc.), and Social Security, we could be setting ourselves up for a big tax bill we may not have been expecting. For our entire lives, we have been trained to load up our tax-deferred buckets because we don't have to pay taxes on that money. In reality, we are just deferring those taxes, and we don't know whether we will find ourselves in a lower tax bracket in retirement or not. All of a sudden, we may be looking at a big loss, and it doesn't have anything to do with the markets.

When we tack on a potential market decline, things can really begin to get messy. So, what can we do? We can start shifting our minds to a new way of looking at things by preparing for the potential tax increases. The Congressional Budget Office (CBO) projects that if the spending in our country goes unchanged, the new tax rates in the current income brackets will be 25%, 63%, and 88%, respectively.[1] What could this do to our retirements when we have deferred those taxes for so many years?

The 2018 Trump tax changes presented a great opportunity for many retirees: It allowed many people to get their taxes at a discount. After all, it's either "pay me now or pay me later."

As I mentioned earlier, provisional income is a key factor in our tax bill. What if the income we took was tax-free?

There is a way to accomplish this. The key in retirement is to pull our money from the right buckets. If we distribute money from our Roth IRAs, this income doesn't show up on the IRS' radar. However, Roth IRAs may not be for everyone. There are income threshold restrictions as well as the requirement to have earned income to qualify. So, what if you find yourself in that situation? You can opt for a Roth conversion – this is where you would take a specified portion each year from a qualified account, such as a traditional IRA, and move it into a Roth. But, be careful; do not attempt this on your own, because it could generate a large tax bill. However, systematically moving funds to a Roth can generate tax-free income in retirement, so if taxes go to 66% or 100%, zero is always zero.

Another tool you could look into is a properly structured life policy, which can help generate tax-free income as well as provide a death benefit that doubles as long-term care protection in the event the need arises. This policy will function much like a Roth IRA, though it is important to note that it is a life insurance vehicle, and there is a cost of insurance associated with it. This vehicle is linked to an index, such as the S&P 500, so the gains will be tax-free as long as it remains in the right structure. The important thing is realizing that long-term care or a death benefit is needed and to conduct adequate research, as not all life insurance retirement plans are created equal.

[1] https://www.thestreet.com/story/14492122/1/how-to-use-the-new-tax-law-to-live-tax-free-in-retirement.html

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